

January 20, 1971

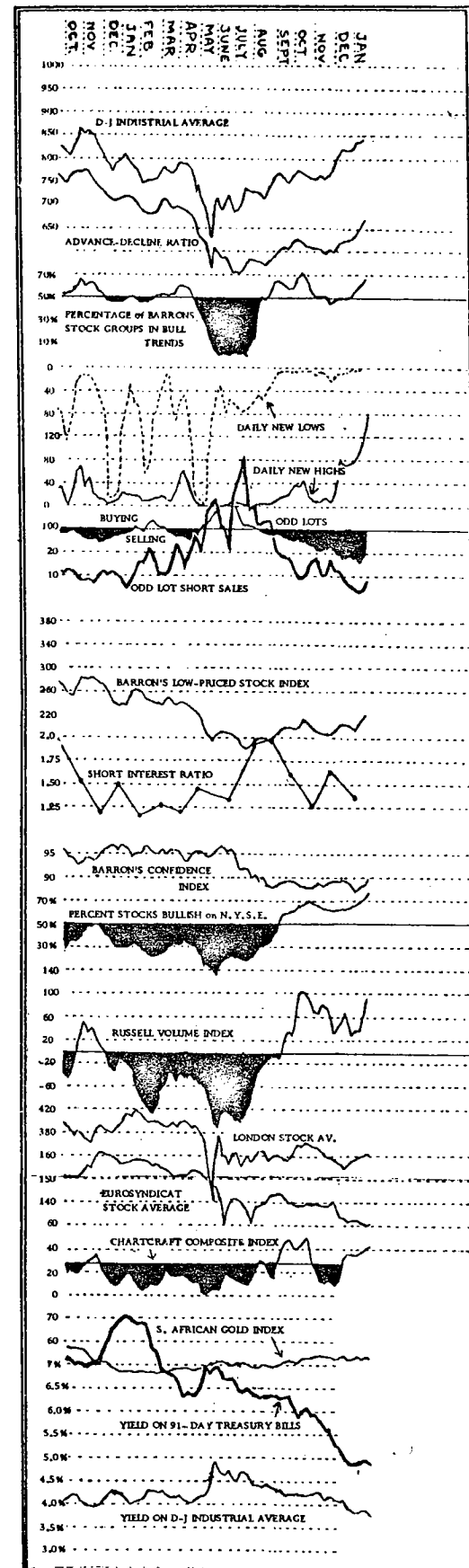
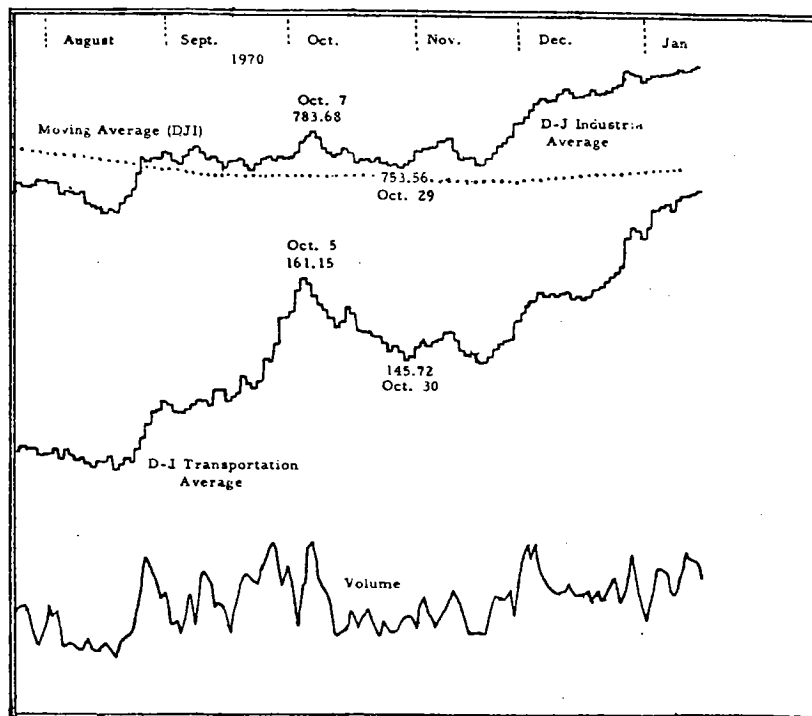
Letter 485

GOOD BYE 1970: As 1970 leaves it is worthwhile reviewing a few of the more interesting statistics. The year 1970 started out very badly. After a smashing downside first quarter, the market turned during May to July, and during the remainder of the year we witnessed a strong bear market (upward) correction. The final figures for the year 1970 show the Dow Industrials up 38.56, the Transports down 4.82 and Utilities up 11.76. Yet 744 stocks rose for the year on the N.Y.S.E. while 1010 declined.

With thanks to Perry Greiner (Rhea, Greiner & Co.) it should be noted that N.Y.S.E. volume from December 31, 1969, through May 26 (the low) was 1.1 billion shares, while from May 26 through December 31, 1970, volume was 1.9 million shares. This means that on the downside each point of decline required 6.4 shares while on the upside each point required 8.9 shares. The inference is that stocks went down easier (with less volume per Dow points) than they advanced.

NOW FOR 1971 — THE PICTURE: In my opinion, the Administration, here as we enter 1971, is verging on the edge of hysteria. While talking about the "good year" (1971) and the "very good year" (1972) ahead, Mr. Nixon is pulling out all the stops, and if galloping wages and inflation are the penalty, then let them gallop. Would that it was all that easy. As the Evans-Novak Political Report (Jan. 6) put it last week, "The President is essentially taking the risk that an expansive fiscal policy with no controls or tough incomes policy will be a sufficient inducement for Arthur Burns to keep the money supply high. We find in talking to businessmen and economists across the country an unsettling gloom about the immediate and distant future, unrelieved by the stock market rally, and wholly foreign to Mr. Nixon's public optimism."

Perhaps sensing this, Mr. Nixon is moving towards a \$15 to \$25 billion 1971 deficit budget, a \$2 billion tax depreciation break for business, a \$10 billion revenue



Despite the frantic moves of the Administration, I see the primary bear market slowly but relentlessly tightening its grip on the economy. By Spring (if not well before) the stock market could find itself out on a very long limb, with the promised business recovery turning into a gathering economic crisis. It should never be forgotten that the long-run fundamentals rule the stock market, while the technical situation rules the short to intermediate term.

Technically, as reviewed in detail in the last Letter, the market was vastly oversold at the May, 1970, lows, following the greatest breadth (i.e., advance-decline ratio) collapse in history. The recovery, coming as it did within the context of a primary bear market, must be considered technical in nature. Robert Rhea in his writings and studies was clear in stating that corrections within bear markets tend to retrace one-third to two-thirds of the previous primary bear legs. Everything which has occurred since the 1970 lows falls, in my opinion, within the context of a typical primary bear market correction — nothing more.

I have often stated that Governments can interrupt or hold back the primary trend temporarily. But all the treasuries and central banks in the Free World can not stave off the ultimate expression of a primary bear market. What we are seeing now is the second all-out effort since 1966 by an Administration to vanquish the forces of the bear. The first effort (1966 to 1968) used up a great deal of precious ammunition, while accomplishing nothing but extending the timing of the bear market. The second effort by the Government began in the latter half of 1970, and it is proving even more damaging and exhausting to U.S. resources and reserves. Worse, this second effort appears to be falling on the deaf ears of both the consumer and business. Capital goods orders are to run about 1.5% above 1970 in 1971, and already some economists are predicting that they will run behind. It is well to remember that every economic expansion since World War II has been led by a rise in the capital goods sector, and with over-capacity in industry, shrinking profits, high inventories and low liquidity, it seems clear that the capital goods sector will be of little use in setting off a business advance in 1971.

Therefore, all eyes are now on the consumer. Here, in my opinion, we see one of the most remarkable set of changes in recent memory. The current national sales success stories are the motorcycle, the Volkswagen, Datsun and Toyota and blue jeans. The luxury item is going out of favor as is the luxury trip, the luxury expense account and the luxury restaurant. The American consumer, beset by inflation and lower per capita income in real dollars, is not only unable to buy more but is fast embracing a new philosophy of consumerism ("if it's junk I don't want it, regardless of design) and what I call "consumer hippy-ism" ("Hey, what do I need all this stuff for, I'd probably be happier without it"). At any rate, I sincerely believe that we are seeing a new psychology among the American people which has actually been fostered by the hypocrisy in advertising and in government. As I predicted it would many months ago, "truth" is becoming the by-word in this nation. If so, we are in for trouble on many fronts.

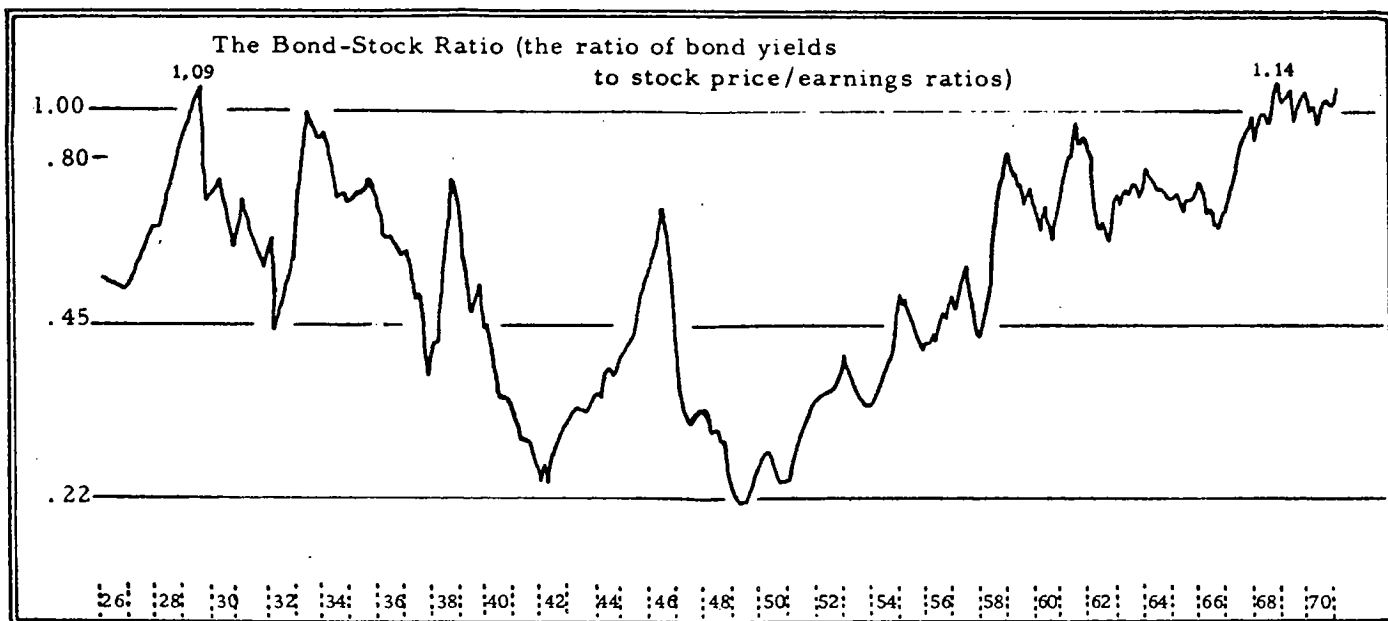
Incidentally, as a late-comment on consumer buying, the announcement by Chrysler that it is cutting back production here in January (following a two-month GM strike) hits me as both ominous and incredible. This is supposed to be inventory build-up time in the auto industry!

As to the market itself, it is notable that the Dow Industrials closed at 842.00 on December 29, 1970, with two more sessions to go to wind up 1970. Since December 29 there have been twelve trading days with volume averaging over 11 million shares per day. Yet the Dow has been unable to move appreciably above its closing of December 29, 1970.

Speculation has been turning rampant, over-the-counter markets have been extremely active, the Administration has been bombarding the press with "optimistic" opinions, yet the market boiler has been churning. The market has become overvalued (see section on the stock-bond ratio), but the majority of investment advisors have nevertheless turned highly bullish (according to Investors Intelligence the ratio of bullish to bearish services is now 68%, highest since this study was started in 1963).

I believe that as never before, stocks have recently been purchased simply as hedges against inflation. Yet I want to warn that stocks are only a good hedge against inflation when their earnings are in a rising trend. A rebound from the profit-crunch of the General Motors strike is not enough of an impetus to change the economic fundamentals. Whether we are about to see a broad rise in market fundamentals now, during this primary bear market, is a very dubious probability, to my mind. Barring that, every point up in the Dow is a rise towards greater danger. For the greater the market correction and the more sluggish the economy, the wider the vacuum which will ultimately be filled by the next major bear market decline.

VALUES: I am indebted to the Bank Credit Analyst of Montreal for their original chart from which I have constructed the bond-stock ratio going back to 1926 (page 3). This is a ratio which is published in Barron's each week in their "Market Laboratory" page. It is the ratio of bond yields to the price/earnings ratio for common stocks.



Broadly speaking, the value of bonds (forgetting safety consideration or ratings) is directly proportional to their yields. In other words, when the bond average yields 7%, bonds are a greater value than when the bond average yields 3%. They simply provide more return for \$1 invested at 7% than at 3%, hence they are a greater value.

By the same token and broadly speaking, the lower the price/earnings ratio for stocks, the greater the value. If the P/E ratio is 8 (i. e., you are paying eight times average earnings) you are getting more earnings for your money than if the P/E ratio is 16 (at which point you are getting half as much in earnings for your money).

The bond-stock ratio rises when the yield on bonds advances or when the P/E ratio on stocks advances. Either phenomenon indicates a trend towards greater value in bonds as compared with stocks. The bond-stock ratio declines when the yield on bonds declines or when the P/E ratio on stocks declines. Either factor implies a trend towards greater value in stocks compared with bonds.

In other words, the bond-stock ratio tends to show when stocks are overvalued or undervalued as compared with bonds. As seen on the chart, the stock-bond ratio has only been up in the stratosphere (above 1.00) on three occasions. In 1929 the ratio rose to 1.09, and that proved to be the unsustainable peak of overvaluation. The ratio then went into a major decline, ending with the extraordinary values of 1942 and 1949.

From that point, the ratio went into a sustained rise to a final top of 1.14 on the week of December 23, 1968. That was one week before the major market top. During the ensuing bear market decline, the ratio receded, touching a low of .90 on the week of May 25, 1970. From there, stocks moved up again, and note on the chart that the ratio has also been rising since May, 1970. On the week ending January 8, 1971, the ratio touched a dangerous 1.12, slightly above the 1929 level and within a hair of the 1968 peak. And that, in a nutshell, is where we find ourselves today.

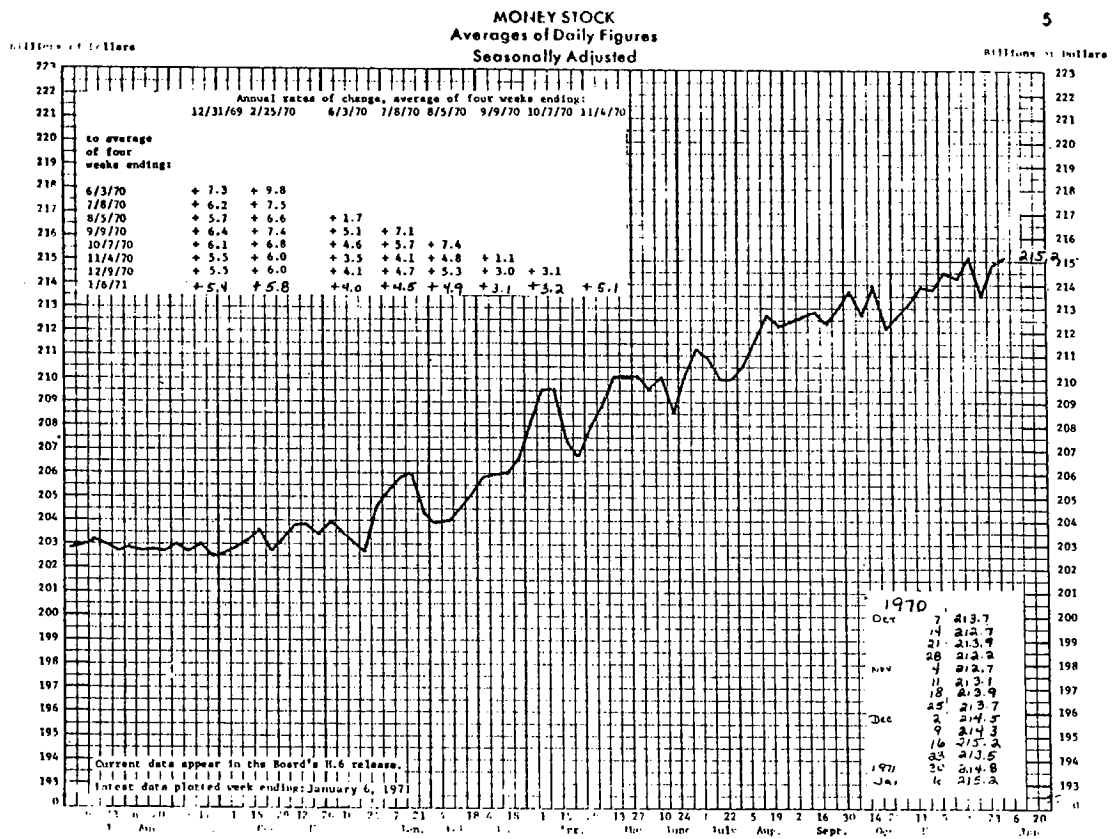
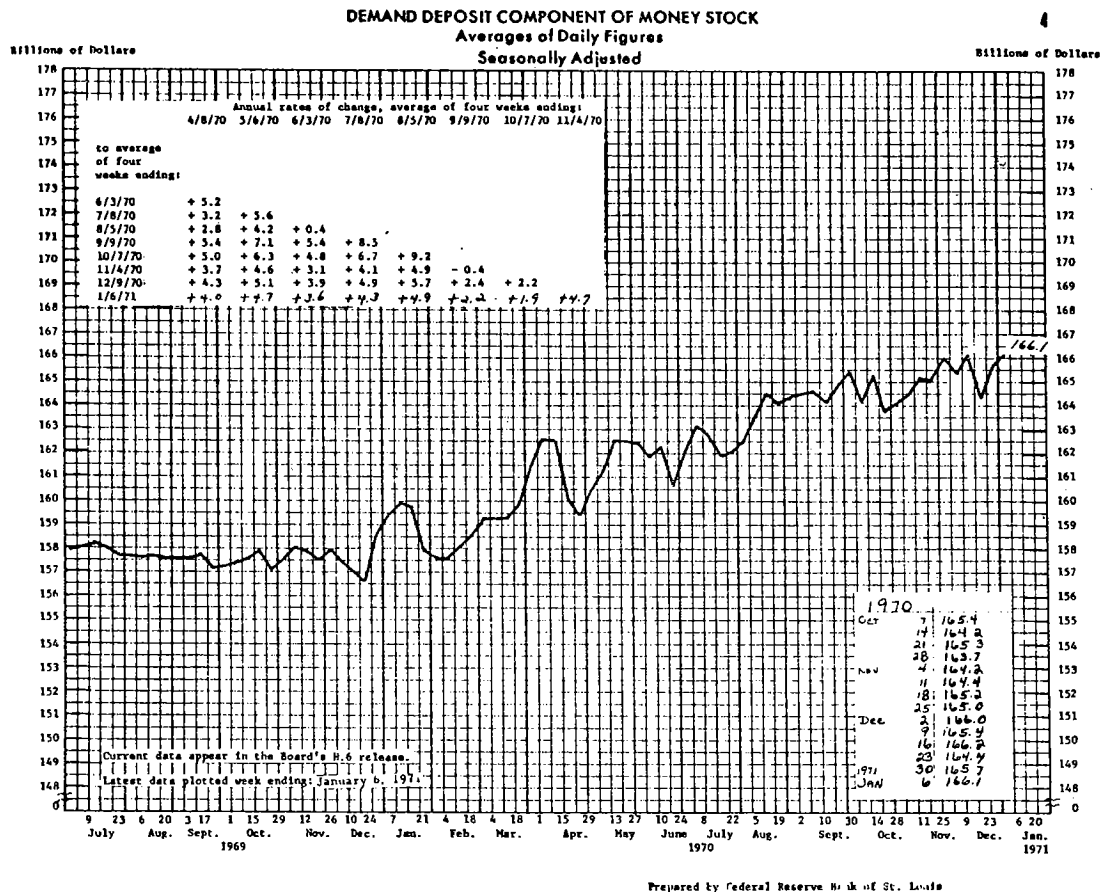
MONEY SUPPLY: One of the most fantastic misconceptions of our times is that "The Government (i. e., the Federal Reserve System) can make the money supply expand or contract at will". It may come as a great shock, even to readers of Dow Theory Letters, but the Government cannot expand the money supply at will, nor can it contract it at will. The truth is that the U.S. monetary system works very much as described by Alden Wells in his recent Quarterly: "The Fed is like an open-end mutual fund. . . . year after year, like a mutual fund, its assets will grow in a boom. Should there be a depression, also like a mutual fund, its assets will probably decline".

I will describe this process briefly a bit later, but I want to say here that the money supply equation in the U.S., although a mighty plus during a bull market when people are borrowing and spending, could be a nightmare during a primary bear market when people are prone to cut borrowing (or actually pay off debt) as well as spend less.

I want to put it as simply as possible without going into too much detail. The U.S. "money stock" which is the widely-followed figure (listed each week in Barron's under their Economic and Financial Indicators column) consists of private demand deposits plus currency in the hands of the public. Under our banking system, each time a person or a business takes out a loan

from a bank, the bank doesn't merely give him the money, what it does is it creates a demand deposit. Let's assume that the XY corporation takes out a loan of \$100. The bank then issues the XY corporation a credit for \$100, and if the bank reserve requirement (which is regulated by the Fed) is say 20%, then the bank must keep \$20 to back that XY Corp's. credit. The bank can then turn around and loan out the remaining \$80. Assuming the AB corporation decides to take out an \$80 loan, the bank then creates a demand deposit of \$80 against the AB Corp. loan, and the process repeats again. This pyramiding operation means that there is a multiplier of 4 for each original \$1 of demand deposit (assuming a 20% reserve requirement).

In other words, money is actually created by the bank; it is not printed or issued by the Government, the bank really creates this money. BUT---it must be remembered that this creation, regardless of whether the reserve requirement is 18% or 30%, is all predicated on someone wanting to borrow money and thus allow the banks to create demand deposits. AND REMEMBER, This process can work in reverse. If people decide to pay off loans, the same effect works in a pyramidal reverse, and demand deposits will then contract.



I have included two charts from the Federal Reserve Bank of St. Louis. The first chart shows the demand deposit component of the money stock, and this is the big factor, consisting of \$166 billion current total money stock. The remaining \$50 billion of the money stock is the actual currency in circulation.

The second chart shows the money stock figures which are so widely circulated and talked about. Note on the second chart that the latest figure on the money stock is \$216 billion, which roughly corresponds to the mid-December, 1970, figure. In other words, despite the much-touted "explosion in money," the money stock has not really grown in the past month—or actually very much in the past three months. Now note on the demand deposit chart that the latest figure of \$166 billion is only \$1 billion above the peak of late-September. Demand deposits have not risen substantially, in fact, during the past five months.

Why have demand deposits stalled? Well, let's take a look at which is happening to loans. I have included tabulations (courtesy the Bank Credit Analyst of Montreal) showing monthly Commercial & Industrial Loans (plus commercial paper) from the November, 1969 peak, at which time they were \$19.5 billion, to the most recent figure of November, 1970, which shows a total of \$3.1 billion. Of that \$16.4 billion, \$9.5 billion represents a run-off of commercial paper alone (much of it due to the Penn-Central bankruptcy fears). But the fact remains that these figures show very clearly that business has been contracting its borrowings sharply.

That contraction of borrowings is due to a number of reasons. High interest rates, slower business, over-capacity, inflation, increasing conservatism, fear of the stock market, etc. What happens, you might ask, if business conditions turn really bad, and business not only halts borrowing but starts to build liquidity by paying off debt? If that trend begins gathering momentum you have major trouble as our system is set up. For the money stock will then continue to contract, even if the Fed lowers bank reserves, cuts the discount rate repeatedly, lowers everything in the books in an effort to make buying and borrowing "attractive". We then turn to that old adage, "You can lead a horse to water, but you can't make him drink".

In the last Letter I included a chart showing the multiple discount rate drops during the 1929-30 period. All those rate drops were water over the dam, because people simply stopped spending and borrowing and the money supply continued to contract.

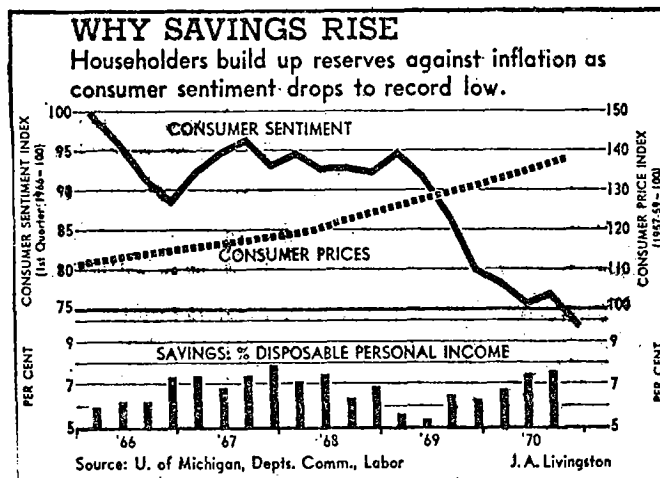
So what does it all boil down to? It boils down to this — psychology and confidence are still king in the markets and in the economy. And the irony of it is that as our system is set up, if sentiment turns overwhelming bearish and people stay on a trend of less spending and less borrowing (in an attempt to cut expenses and get increasingly liquid) the money stock is doomed to contract. Thus the U.S. monetary system is a great vehicle of leverage during a bull market boom. During a primary bear market, the system will prove to be a detriment, and I will go so far as to say that as the Federal Reserve System is set up today, it will not survive a major bear market. That opinion will be proved correct or uncorrect as the current "slow-starting" primary bear market picks up steam over the period ahead.

The January 9 issue of Business Week carried an article entitled, "Consumers Hold the Key". The article states that business won't hold the key this year, but "Instead, 1971 will be the year of the consumer". I rather agree, and in view of this I am including a chart showing a least one factor which is affecting consumers' action. That is the steady rise in prices. Instead of laying away inventory, the consumers are now strictly bargain-minded, and bargains mean less profits to business. On top of this, it was announced that November, 1970, saw a drop of \$302 million in consumer's credit, the largest drop in the 28 years in which these figures have been kept. I might add that there is still \$99.7 billions in consumer credit outstanding.

NOTES: Bill Gordon of New York called me last week to tell me that he had made an error in the Dow Short Interest ratio. The

Commercial & Industrial Loans plus Commercial Paper**

January	1969	+ 12.5
February	"	+ 15.7
March	"	+ 15.2
April	"	+ 18.1
May	"	+ 18.4
June	"	+ 17.3
July	"	+ 17.5
August	"	+ 18.1
September	"	+ 18.7
October	"	+ 19.5
November	"	+ 18.2
December	"	+ 19.4
January	1970	+ 17.3
February	"	+ 17.0
March	"	+ 16.4
April	"	+ 14.0
May	"	+ 14.4
June	"	+ 11.2
July	"	+ 11.2
August	"	+ 10.1
September	"	+ 7.9
October	"	+ 5.5
November	"	+ 3.1



Page 6 December figure
was .74, not the
figure of .47 previously announced.
The .74 figure is bearish but not
as unbelievably bearish as the .47
figure. The December figure of
.74 is the lowest figure since the
.57 of May, 1970.

The December dividend compu-
tations have come in from Standard
& Poor, and they show that
dividend increases and resumptions
minus decreases and omissions
for December, 1970, were 71.
This compares with a much
higher figure of 127 for the same
month during 1969. This is the
worst showing (the lowest Dec.
differential figure) since 1960.

And then after all this frantic, first-
hand experience in the "real" world, I
had a month to step back a little. A
couple of days I put in reading about the
environment challenged a lot of my basic
assumptions.

We are now at the point, I read, give
or take a few years, where the incre-
mental advantage of another dollar of
gross national product is out weighed
by corresponding incremental disadvan-
tages of resource depletion and waste
disposal. Especially if that incremental
dollar represents another unit of horse-
power in some young entrepreneur's
Lear Jet. According to these eminent
scientists, we are borrowing from the
future just as recklessly as Cort did. We
are looking for infinite growth on a finite
planet—impossible as a successful chain
letter, but enticing if you are among the
first to sign up.

"Standard of living," they say, is com-
peting with "quality of life." *The Wall
Street Journal*, they hope, will some day
say, "The GNP took a turn for the better
this month as it resumed its descent, in-
terrupted last month by what now ap-
pears to have been merely a statistical
aberration. The White House issued a
statement taking credit for this encour-
aging development."

Am I the last of the super consumers?
Am I selling my lava lamp because I am
poor now or because I've changed? Is
this why my generation is having trouble
deciding which direction is up and what
is worth working for?

Are the scientists right? If they are,
will America believe them? If so, will
American business be able to cope with
such new values and ground rules? How?
That's what I want to ask the Harvard
Business School.

NEW YEAR COMMENT: In my opinion, belief in perpetual growth may ultimately destroy capitalism. There is nothing
in the capitalistic system which guarantees that next year must or will be better than this year. In fact, the very insistence
on such a progression is beginning to have the most serious effects on this system, mainly in the realm of prices (inflation)
and debt. Furthermore, our politicians have now accepted the "ever higher" principle as a fact of life, and they are
actively seeking to find ways to force each year to be bigger than last year. The damage they have done in this pursuit
is beyond belief, and much of it borders on pure immorality.

Luckily, a few of our younger people are now beginning to think (some of today's youth seems to have re-discovered the
art of asking poignant questions). The following is the finale from a fascinating article in New York Magazine by a young
man named Tobias who held top positions at a few recently-collapsed go-go corporations:

This is by Kenneth Watt, director of Ecology, Univ. of Calif. at Davis, in which
he discusses a basic fallacy in planning, namely, that economic variables must grow
forever. Here is Watt's description of a "design for disaster", from Center Magazine.
(Below)

The Infinity Principle: "The belief
in infinite growth can lead to major dis-
aster. The essence of the problem con-
fronting all industry is revealed more
dramatically in the airlines than any-
where else. Take these figures: Reve-
nue from passenger seat miles on the
world's major trunk airlines has been
growing about twelve to fourteen per
cent per annum, compounded annu-
ally, for about two decades. Most of
the world's airlines, particularly the
American ones, assume this growth
will be continued indefinitely. But it
can't be. In just the last year revenue
per passenger seat miles has been
growing at only about six per cent per
annum."

Jumbo Investments: "How do the
airlines view these statistics? Simply
as a temporary phenomenon. Hence
they see no implications for their pur-
chases of new capital equipment. Be-
cause of this obliviousness they have
made incredible investments in jumbo
jets and are about to make an even
more incredible round of investments
in air buses for which they may have

no business at all. In actuality the air-
lines could have dealt with any in-
crease in business for the next several
years quite handily with the equipment
they already had.

"The result is that the airlines are
running into debt at a staggering rate.
During the first half of 1970 a pre-tax
loss of \$101 million on *domestic* busi-
ness alone was suffered by the three
major airlines (United, TWA, Ameri-
can). The magnitude of these losses
is truly fantastic.

"The basic problem — and they
ought to understand it from flying
around the planet — is that they oper-
ate on a small round ball in empty
space and it has limits. But they can't.
I spent hours, for example, with one
of the leading fuel planning engineers
for a huge international carrier trying
to help him realize that there is a pro-
cess operating that will limit the avail-
ability of fuel and the market for air
travel. He just couldn't see it. He
simply didn't believe that things can-
not grow exponentially forever.

"I think evidence that what I'm say-
ing is not nonsense is that the few air-
lines which looked at the situation and
arrived at the same conclusion —
namely that capacity was leading de-
mand — decided not to go into the
jumbo jets for quite a long while. They
made money this year. KLM made
\$25 million in the first quarter.

"About twenty very large corpora-
tions in the airline operations business
are in danger of going bankrupt in the
next twenty-four months. Then you
have three other gigantic corporations
— Boeing, McDonald-Douglas and
Lockheed — and all their subcon-
tractors also in danger of bankruptcy.
And then their bankers. There's going
to be an escalator effect from all this
unless it's checked rapidly."

The Way Out: "The only way a
modern technological society can keep
healthy is to have a much more sharply
shifting mix of gross national product
than we have now — a shift away
from manufacturing and transporta-
tion activities, both of which consume
energy, towards service activities
which do not consume energy. There
is no *other way*."